Testimony of
Karen J. Hedlund
Partner, Nossaman, Guthner, Knox & Elliott, LLP

Before the
Subcommittee on Highways and Transit
Committee on Transportation and Infrastructure
U.S. House of Representatives

Hearing on "Public-Private Partnerships: Financing and Protecting the Public Interest"

February 13, 2007

Good afternoon, Mr. Chairman, Ranking Member Duncan and Members of the Committee. My name is Karen Hedlund and I am a partner of the law firm of Nossaman, Guthner, Knox & Elliott, LLP. It is my pleasure to review with you today statutory and contract provisions used to protect the public interest in carrying out public-private partnership (PPP) programs. My firm has had the privilege of advising on PPPs in over 15 states in, including Alaska, California, Florida, Georgia, Massachusetts, Minnesota, Nevada, North Carolina, Oregon, Texas, Utah, Virginia and Washington. Our advice is frequently sought on PPP legislation, and I will describe the varying approaches that the states have taken in this area.

I was honored to be called to speak to this Subcommittee in May 2006 when I described how state transportation agencies select private partners and the major projects being financed through PPPs. My remarks today will be focused more particularly on discrete public policy issues that arise in these transactions and how these are resolved through legal and contract requirements. My remarks will focus primarily on use of PPPs to finance and deliver new facilities. I will also briefly mention some additional issues that arise in the context of the long-term concessioning of existing assets.

State PPP Enabling Legislation

As of today over 24 States have adopted legislation authorizing the contracting with private entities for the financing, delivery and operation of new transportation facilities. As with other governmental activities, such laws vary greatly from State to State in their scope and detail,[1] including with respect to such matters as the agencies authorized to implement PPPs; the type, number or location of eligible transportation facilities; project selection and proposal approval; procurement processes; contract types; the role of regional planning agencies, state transportation commissions and advisory committees: and funding and bonding mechanisms.

[1] Compare Texas Transportation Code, §§ 223.201-209 with South Carolina Code Ann. § 57-3-200.

While there are differences in approach, there are many similarities as well. What the states have in common in their approach to PPPs is that they view them as but one "tool in the toolbox" to be used to advance important mobility projects for which traditional sources of funding are lacking.

The basic approach taken in state authorizing laws is two-fold: first, these laws provide the necessary authority to enter into agreement with private sector entities for a combination of services, including design, construction, financing, operation and maintenance. Secondly, they set out the conditions for exercise of this authority. State legislation may itemize issues that should be addressed in PPP agreements,[2] but they usually forbear from prescribing particular solutions. Many state transportation agencies have also adopted detailed rules and guidelines to implement their PPP authority.[3]

Some of the key issues include the following:

How can competition be encouraged?

Most States authorize the responsible public entity to solicit PPPs through a formal request for proposal process. This approach contemplates that the responsible public entity will evaluate its projects in the planning stage to determine which of them may be appropriate for a PPP, taking into account its transportation project priorities, project feasibility, and the agency's relative capabilities to complete the project on its own. Some states also permit consideration of unsolicited proposals. These provisions enable the private sector to propose innovative solutions to mobility that the normal state planning processes might not have produced, provided they satisfy the criteria outlined in the governing statutes and regulations, and are consistent with the state's overall transportation plans. The public entity does not have any obligation to accept an unsolicited proposal, but if the entity is interested in pursuing it, applicable laws or regulations will typically require issuance of a request for competitive proposals to enable interested qualified teams to prepare meritorious competing proposals.[4]

What is the appropriate procurement process?

PPPs require flexibility in the procurement process because such contracts go beyond mere construction to include design as well as operations, maintenance, and, in some cases, financing. Public agencies need to be able to select a procurement process that is most appropriate for a particular project. These might include, for example, calls for projects, competitive RFQs and RFPs, qualifications review followed by an evaluation of proposer concepts, and selection based on financial terms such as return on equity rather than on price.

---

[2] See, e.g. Oregon. Revised Statutes § 367.806(b)(2). Virginia Code § 56-566.

[3] See, e.g., the Commonwealth of Virginia, Public Private Transportation Act of 1995, Implementation Guidelines, http://www.virginiadot.org/business/ppta-Guidelines.asp.

4 Georgia's Public Private Initiatives Act, Georgia. Code Annotated §§ 32-2-78 to 32-2-80, originally authorized only unsolicited proposals but was later amended in May 2005 by SB 270 to permit solicitation of proposals. The amendment also increased the minimum time for receipt of competitive proposals from 90 to 135 days.

To effectuate such procurements, exemptions need to be provided from traditional low-bid "design-bid-build" procurement laws so that contracts may be awarded on the basis of "best value" taking into account both short and long-term benefits of the project proposal. In evaluating proposals and awarding a contract, the government sponsor needs to be able to take into account not just the proposed capital cost, but also the value of the commitments made by the private partner, risks associated with the proposal, and public policy issues.[5]

State PPP laws, regulations and guidelines typically call for a two-step procurement process using procedures modeled after practices and procedures that have been used successfully at the federal level.[6] Proposers must first demonstrate their qualifications to undertake a project based on relevant experience in development, design, construction, financing and/or operation of projects with attributes similar to the project being procured; the financial resources they bring to the undertaking and their legal structure. Step two involves issuance of a request for proposals to the shortlisted firms, receipt and evaluation of proposals, and award to the firm that submitted the best value proposal.

How can the integrity of the procurement process be maintained?

Low-bid procurement processes, involving award of construction contracts based solely on price, generally contemplate that bids will be made public upon opening. However, where proposals are being evaluated based on a range of technical issues, as well as price, the evaluation process can take several days, even weeks. In order to maintain the integrity of the process, especially where a second round of "best and final offers" may be sought, it is critical that the agency be able to maintain the confidentiality of the proposals during the review process.[7] . Following actual execution of the contract, almost all agencies release to the public the contracts themselves, the proposals and relevant evaluation information, excepting only proprietary data, such as the financial statements of private companies. This ensures a transparent process.

Where unsolicited proposals are put out for competition, competitors need to know enough about the initial proposal to address essentially the same project. States have taken a variety of approaches with respect to how much of the initial proposal is described in the request for competition. To encourage innovative proposals, sponsoring agencies need to be able to protect the unique intellectual property of the initial proposal from unfair use by other firms in preparing their competitive proposals.

---

[5] Virginia's Public-Private Partnerships Act lists non-price factors that may be considered in evaluating proposals. Virginia Code § 56-573.1.

[6] Federal Acquisition Regulations, 48 CFR 36.300 et seq.

[7] See, e.g., Texas Transportation Code § 223.204; Oregon Revised Statutes §367.806(7).

How should the term of the PPP agreement be determined?

Some statutes establish a maximum number of years for the duration of the public-private agreement.[8] The term of any specific agreement should be established with regard to financial feasibility of the project. Projects with weak revenue streams may require longer term for the private operator to be able to achieve its targeted rate of return. Projects with lower revenue risk, such as those where the concessionaire is paid from state funds rather than user fees, can have relatively shorter terms. Some transactions have been structured using "shadow tolls" or "availability payments" involving annual payments by the government from other public sources, based on the actual performance of the project.[9]

On robust projects, the length of the term will also impact the amount of upfront concession fee that the private entity may be willing to bid. The trade-off between term and concession value is a public-sector decision.

How can increases in user fees be limited?
Howe can unreasonable private operator profits be controlled?

One of the most important benefits of public-private partnerships is the contribution of private capital to pay the costs of design and construction of a project, as well as long-term operation and maintenance, rehabilitation and upgrades. Typically the private partner is repaid, and is permitted to earn a return on its investment, through assignment of a stream of revenues which consists of an interest in the tolls or other fees paid by users of the project.

Such agreements are structured to cap, directly or indirectly, toll rates and private sector returns; they do not guarantee a profit. In other words private investors have a ceiling on the profits they can make but no floor on how much money they can lose. If in fact private investors are losing money on a project, generally speaking the public agency sponsor has no legal or moral obligation to assist—and in practice, they do not.

Thus, authorizing statutes address who has rate-setting authority to impose user fees and under what circumstances may they be changed or otherwise reviewed. Authorizing legislation must contain provisions permitting the adjustment of toll rates to allow the private partner to obtain a reasonable rate of return on its initial capital investment, repay its lenders and pay the costs long term operations and maintenance and other improvements, which are subject to inflation. However, the decision on how much and how fast user fees should be permitted to rise is a public sector decision involving significant public policy considerations, and public input may be

[8] See, e.g. Texas Transportation Code § 227.023(f) which limits public-private agreements for the Trans-Texas Corridor to fifty years. Colorado permits a franchise or long-term lease of up to 99 years, Colorado Revised Statutes §43-1-1202(1)(d)(II).

[9] The proposed concession agreement for the Miami Port Tunnel will be the first transaction in the United States involving an "availability payment" scheme. The proposed term of the concession is 35 years. http://www.portofmiamitunnel.com/faq_finan.html

sought. The final decisions can be implemented through contract terms specifying maximum annual toll rate adjustments, which may be tied to a formula or an index.

Laws that require public commission approval of specific increases tend to create uncertainties that may discourage private investment. The maximum profits that a private entity can secure is be controlled through the use of other contractual devices. For example, contracts can require that if the private entity's rate of return exceeds a specified percentage, excess revenues are returned to the sponsor agency. Such revenue sharing provisions also provide the governmental authorities the option of requiring the private operator to lower user fees to the level where excess revenues are minimized.

In congested corridors, where mobility and environmental considerations require time of day variations, the public sector may want to require that the private operator implement "variable pricing," where tolls are increased in order to assure free flow of traffic. In this case public agencies use contractual provisions strictly regulating allocations of resulting revenues between the private entity and the public sector.

Are there reasonable approaches to the issue of unplanned revenue impacting facilities?

To finance against a long-term stream of revenues, lenders and investors need to be able to make projections of revenues based on reasonable assumptions about future demand. The public sector, on the other hand, needs to be free to make investments in the future to meet actual growth, foreseen or unforeseen.

Today PPP agreements have moved away from prohibiting the public sector from building what have been termed "competitive facilities," but are more accurately termed "unplanned, revenue impacting facilities. The public sector should not be enjoined from making whatever public investments are required to meet future public needs. There was only one project actually built that allowed that—the SR 91 facility; the market has evolved dramatically away from that in the 16 years hence.

Instead, agreements now provide for possible compensation to be paid to the private operator if and only if the construction of facilities not currently planned result in a proven reduction in revenue produced the privately operated facility. And in making their initial projections, the private investors can be required to take into account everything that may be included in the region's long-term plans, whether or not funding is currently provided for.[10]

How can long-term performance be assured?

One of the most often-expressed fears about public-private partnerships is that the private operator, in an effort to maximize its profits, will fail to maintain the asset or make necessary improvements. In contrast many observers point out that, in fact, the private entity will be highly

[10] This approach is codified in California Streets and Highways Code § 143(d)(3).

motivated to maintain the facility in top condition in order to protect its investment and attract the greatest number of customers.

Contract terms can secure these expectations with detailed performance requirements that have become standard in these transactions. Additional security for the operator's performance can be provided through requiring deposits to be made to reserves for operation and maintenance and rehabilitation ahead of distributions to equity investors. Other forms of financial security can be required to assure that the facility is in good repair when it is handed back to the public at the end of the term of the agreement. These state laws and contract provisions also provide the public sponsor the ability to monitor, inspect and audit the private operator's performance. In addition, the operator's lenders will also have a strong interest in policing the operator to avoid any threat of contract termination due to the private operator's default.

What if the private operator defaults?

Concession contracts will typically provide that if the private operator materially defaults in carrying out its obligations or becomes bankrupt or insolvent, the private sponsor can terminate the agreement and either contract with another entity to operate the facility or step in and operate the facility itself. As a result, some state statutes address the issue of whether tolls or user fees can continue to be imposed by the governmental entity or a substitute operator after termination of the original agreement and whether such tolls may be used to satisfy the liens of the original operator's lenders.[11]

Most public agencies retain the right to terminate a contract "for convenience" when they deem it in the public interest, as a result of changed circumstances or a change in public policy, but the private investors will require that in such event the public sector pay "fair value" to the private operator, as would be the case in a condemnation proceeding.

Can PPPs be used to avoid prevailing wage and WMBE requirements?

PPP projects are not generally exempted from other state law requirements applicable to public works projects, such as prevailing wage and women and minority business enterprise requirements, at least if they receive any public funds. PPP projects that receive federal support, including grant funding, TIFIA and Private Activity Bonds, are likewise subject to all otherwise applicable federal requirements, such as Buy America and Davis Bacon.

What other issues arise in long-term leases of existing assets?

These statutes I have described above, primarily relate to the development of <u>new</u> transportation facilities. With respect to long-term concessioning of <u>existing</u> assets, specific authorizing legislation may be enacted as was the case for the Chicago Skyway and Indiana Tollroad

[11] See, e.g., Virginia Code §56-568.

leases.[12] . This class of transactions is very different than the public-private partnerships employed primarily to build capacity that otherwise would be deferred for many years or not built at all. The monetizing of existing state-owned enterprises involves a number of issues in addition to those discussed above. These include such things as the need for independent verification of asset value, how proceeds of the transaction should be used and what protections should be afforded existing public employees.[13]

Conclusion

Public-private partnerships can be a powerful tool to deliver needed infrastructure improvements, especially where traditional public sources of funding are lacking. The authorizing legislation in many states reflects significant thoughtfulness about the proper processes to be used to implement PPPs in such a way that the public interest is protected over the term of the agreements. Public agencies also have at their disposal a wealth of contract provisions used around the world to insure that private partners keep their end of the bargain and not take unfair advantage of the public in operating public use facilities.

Justice Louis D. Brandeis wrote in 1932, “It is one of the happy incidents of the federal system that a single courageous state may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country."[14]

The experiments of individual states with public-private partnerships are proving successful in providing new funding to meet mobility and safety challenges. These state endeavors should contribute to new ways to help provide a national transportation system that serves the social and economic needs of the entire county.

.

[12] With respect to the lease of the Indiana Toll Road, see Indiana General Assembly, 2006 Session, HEA 1008.

[13] See labor provisions in act authorizing lease of Midway Airport, 94th General Assembly, State of Illinois, Public Act 094-0750.

[14] New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932).

Karen J. Hedlund
Nossaman, Guthner, Knox & Elliott, LLP
2111 Wilson Blvd., Suite 1110
Arlington, VA 22201-3001
703-682-1751; fax 703 682-1755